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Piece of my mind

The Federal Reserve Bank of New York has invited some of its public critics to visit the bank to unburden themselves of their criticisms. On March 12, it was your editor's turn. The text of his remarks follows.

My friends and neighbors, I thank you for this opportunity. You know, we *are* friends and neighbors. *Grant's* makes its offices on Wall Street, overlooking Broadway, a 10-minute stroll from your imposing headquarters. For a spectacular vantage point on the next ticker-tape parade up Broadway, please drop by. We'll have the windows washed.

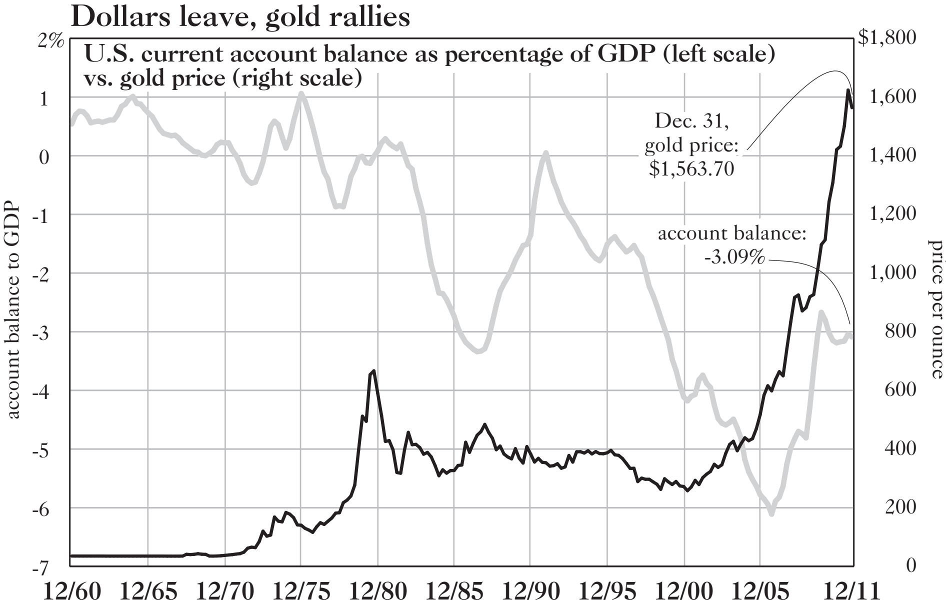
You say you would like to hear my complaints, and, on the one hand, I do have a few, while on the other, I can't help but feel slightly hypocritical in dressing you down. What passes for sound doctrine in 21st-century central banking—so-called financial repression, interest-rate manipulation, stock-price levitation and money printing under the frosted-glass term "quantitative easing"—presents us at *Grant's* with a nearly endless supply of good copy. Our symbiotic relationship with the Fed resembles that of Fox News with the Obama administration, or—in an earlier era—that of the *Chicago Tribune* with the Purple Gang. *Grant's* needs the Fed even if the Fed doesn't need *Grant's*.

In the not quite 100 years since the founding of your institution, America has exchanged central banking for a kind of central planning and the gold standard for what I will call the Ph.D. standard. I regret the changes and will propose reforms, or, I suppose, re-reforms, as my program is very much in accord with that of the founders of this institution. Have you ever read the Federal Reserve Act? The authorizing legislation projected a body "to provide for the establishment of the Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper and to establish a more effective supervision of banking in the United States, and for other purposes." By now can we identify the operative phrase? Of course: "for other purposes."

You are lucky, if I may say so, that I'm the one who's standing here and not the ghost of Sen. Carter Glass. One hesitates to speak for the dead, but I am reasonably sure that the Virginia Democrat, who regarded himself as the father of the Fed, would skewer you. He had an abhorrence of paper money and government debt. He didn't like Wall Street, either, and I'm going to guess that he wouldn't much care for the Fed raising up stock prices under the theory of the "portfolio balance channel."

It enflamed him that during congressional debate over the Federal Reserve Act, Elihu Root, Republican senator from New York, impugned the anticipated Federal Reserve notes as "fiat" currency. Fiat, indeed! Glass snorted. The nation was on the gold standard. It would remain on the gold standard, Glass had no reason to doubt. The projected notes of the Federal Reserve would—of course—be convertible into gold on demand at the fixed statutory rate of $20.67 per ounce. But more stood behind the notes than gold. They would be collateralized, as well, by sound commercial assets, by the issuing member

Dollars leave, gold rallies



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bank and—a point to which I will return—by the so-called double liability of the issuing bank's stockholders.

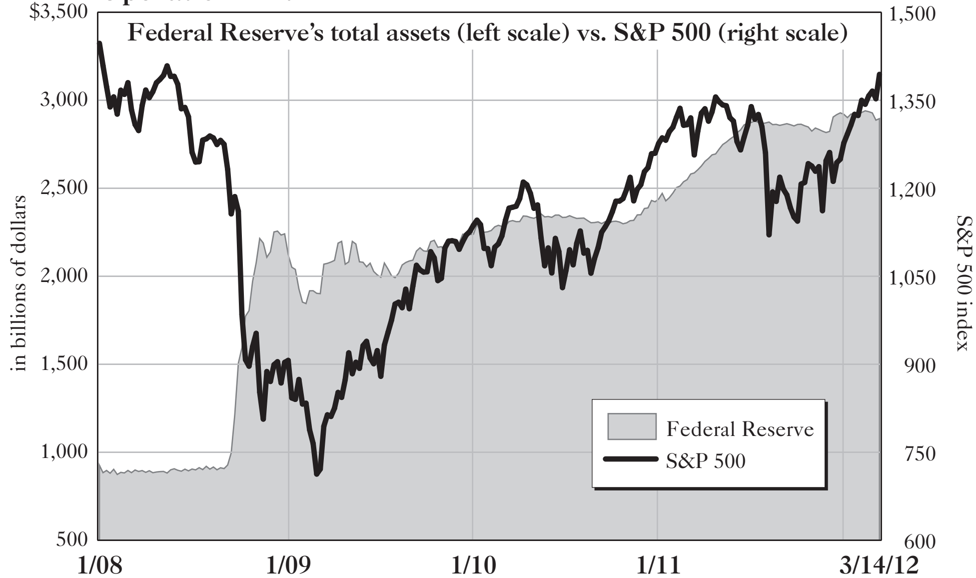
If Glass had the stronger argument, Root had the clearer vision. One can think of the original Federal Reserve note as a kind of derivative. It derived its value chiefly from gold, into which it was lawfully exchangeable. Now that the Federal Reserve note is exchangeable into nothing except small change, it is a derivative without an underlier. Or, at a stretch, one might say it is a derivative that secures its value from the wisdom of Congress and the foresight and judgment of the monetary scholars at the Federal Reserve. Either way, we would seem to be in dangerous, uncharted waters.

As you prepare to mark the Fed's centenary, may I urge you to reflect on just how far you have wandered from the intentions of the founders? The institution they envisioned would operate passively, through the discount window. It would not create credit but rather liquefy the existing stock of credit by turning good-quality commercial bills into cash—temporarily. This it would do according to the demands of the seasons and the cycle. The Fed would respond to the community, not try to anticipate or lead it. It would not override the price mechanism—as today's Fed seems to do at every available opportunity—but yield to it.

My favorite exposition of the sound, original doctrines is a book entitled, "The Theory and Practice of Central Banking," by H. Parker Willis, first secretary of the Federal Reserve Board and Glass's right-hand man in the House of Representatives. Writing in the mid-1930s, Willis pointed out that the Fed fell into sin almost immediately after it opened for business in 1914. In 1917, after the United States entered the Great War, the Fed set about monetizing the Treasury's debt and suppressing the Treasury's borrowing costs. In the 1920s, after the recovery from the short but ugly depression of 1920-21, the Fed started to implement open-market operations to sterilize gold flows and steer a desired macroeconomic course.

"Central banks," wrote Willis, glaring at the innovators, "…will do wisely to lay aside their inexpert ventures in half-baked monetary theory, meretricious statistical measures of trade, and hasty grinding of the axes of speculative interests with their suggestion that by doing so they are achieving some sort of vague 'stabilization' that will, in the long run, be for the greater good."

Operation Lift



source: The Bloomberg

Willis, who died in 1937, perhaps of a broken heart, would be no happier with you today than Glass would be—or I am. The search for "some sort of vague stabilization" in the 1930s has become a Federal Reserve obsession at the millennium. Ladies and gentlemen, such stability as might be imposed on a dynamic capitalist economy is the kind that eventually comes around to bite the stabilizer.

"Price stability" is a case in point. It is your mandate, or half of your mandate, I realize, but it does grievous harm, as defined. For reasons you never exactly spell out, you pledge to resist "deflation." You won't put up with it, you keep on saying—something about Japan's lost decade or the Great Depression. But you never say what deflation really is. Let me attempt a definition. Deflation is a derangement of debt, a symptom of which is falling prices. In a credit crisis, when inventories become unfinanceable, merchandise is thrown on the market and prices fall. That's deflation.

What deflation is not is a drop in prices caused by a technology-enhanced decline in the costs of production. That's called progress. Between 1875 and 1896, according to Milton Friedman and Anna Schwartz, the American price level subsided at the average rate of 1.7% a year. And why not? As technology was advancing, costs were tumbling. Long before Joseph Schumpeter coined the phrase "creative destruction," the American economist David A. Wells, writing in 1889, was explaining the consequences of disruptive innovation.

"In the last analysis," Wells proposes, "it will appear that there is no such thing as fixed capital; there is nothing useful that is very old except the precious metals, and life consists in the conversion of forces. The only capital which is of permanent value is immaterial—the experience of generations and the development of science."

Much the same sentiments, and much the same circumstances, apply today, but with a difference. Digital technology and a globalized labor force have brought down production costs. But, the central bankers declare, prices must not fall. On the contrary, they must rise by *2%* a year. To engineer this up-creep, the Bernankes, the Kings, the Draghis—and yes, sadly, even the Dudleys—of the world monetize assets and push down interest rates. They do this to conquer deflation.

But note, please, that the suppression of interest rates and the conjuring of liquidity set in motion waves of speculative lending and borrowing. This artificially induced activity serves to lift the prices of a favored class of asset—houses, for instance, or Mitt Romney's portfolio of leveraged companies. And when the central bank-financed bubble bursts, credit contracts, leveraged businesses teeter, inventories are liquidated and prices weaken. In short, a process is set in motion resembling a real deflation, which then calls forth a new bout of monetary intervention. By trying to forestall an imagined deflation, the Federal Reserve comes perilously close to instigating the real thing.

The economist Hyman Minsky laid down the paradox that stability is itself destabilizing. I say that the pledge of a stable funds rate through the fourth quarter of 2014 is hugely destabilizing. Interest rates are prices. They convey information, or ought to. But the only information conveyed in a manipulated yield curve is what the Fed wants. Opportunists don't have to be told twice how to respond. They buy oil or gold or foreign exchange, not incidentally pushing the price of a gallon of gasoline at the pump to $4 and beyond. Another set of opportunists borrow short and lend long in the credit markets. Not especially caring about the risk of inflation over the long run, this speculative cohort will fund mortgages, junk bonds, Treasurys, what-have-you at zero percent in the short run. The opportunists, a.k.a. the 1 percent, will do fine. But what about the uncomprehending others?

I commend to the Federal Reserve Bank of New York Financial History Book Club (if it doesn't exist, please organize it at once) a volume by the British scholar and central banker, Charles Goodhart. Its title is "The New York Money Market and the Finance of Trade, 1900-1913." In the pre-Fed days with which the history deals, the call money rate dove and soared. There was no stability—and a good thing, Goodhart reasons. In a society predisposed to speculate, as America was and is, he writes, unpredictable spikes in borrowing rates kept the players more or less honest. "On the basis of its record," he writes of the Second Federal Reserve District before there was a Federal Reserve, "the financial system as constituted in the years 1900-1913 must be considered successful to an extent rarely equaled in the United States." And that not withstanding the Panic of 1907.

My reading of history accords with Goodhart's, though not with that of the Fed's front office. If Chairman Bernanke were in the room, I would respectfully ask him why this persistent harking back to the Great Depression? It is one cyclical episode, but there are many others. I myself draw more instruction from the depression of 1920-21, a slump as ugly and steep in its way as that of 1929-33, but with the simple and interesting difference that it ended. Top to bottom, spring 1920 to summer 1921, nominal GDP fell by 23.9%, wholesale prices by 40.8% and the CPI by 8.3%. Unemployment, as it was inexactly measured, topped out at about 14% from a pre-bust low of as little as 2%. And how did the administration of Warren G. Harding meet this macroeconomic calamity? Why, it balanced the budget, the president declaring in 1921, as the economy seemed to be falling apart, "There is not a menace in the world today like that of growing public indebtedness and mounting public expenditures." And the fledgling Fed, face to face with its first big slump, what did it do? Why, it tightened, pushing up short rates in mid-depression to as high as 8.13% from a business cycle peak of 6%. It was the one and only time in the history of this institution that money rates at the trough of a cycle were higher than rates at the peak, according to Allan Meltzer.

But then something wonderful happened: Markets cleared, and a vibrant recovery began. There were plenty of bankruptcies and no few brickbats launched in the direction of the governor of the New York Fed, Benjamin Strong, for the deflation that cut an especially wide and devastating swath through the American farm economy. But in 1922, the first full year of recovery, the Fed's index of industrial production leapt by 27.3%. By 1923, the unemployment rate was back to 3.2%. The 1920s began to roar.

And do you know that the biggest nationally chartered bank to fail during this deflationary collapse was the First National Bank of Cleburne, Texas, with not quite $2.8 million of deposits? Even the forerunner to today's Citigroup remained solvent (though for Citi, even then it was a close-run thing, on account of an oversize exposure to deflating Cuban sugar values). No TARP, no starving the savers with zero-percent interest rates, no QE, no jimmying up the stock market, no federal "stimulus" of any kind. Yet—I repeat—the depression ended. To those today who demand ever more intervention to cure what ails us, I ask: Why did the depression of 1920-21 ever end? Given the policies with which the authorities treated it, why are we still not ensnared?

If you object to using the template of 1920-21 as a guide to 21st-century policy because, well, 1920 was a long time ago, I reply that 1929 was a long time ago, too. And if you persist in objecting because the lessons to be derived from the Harding depression are unthinkably at odds with the lessons so familiarly mined from the Hoover and Roosevelt depression, I reply that Harding's approach worked. The price mechanism is truer and enterprise hardier than the promoters of radical 21st-century intervention seem prepared to acknowledge.

In notable contrast to the Harding method, today's policies seem not to be working. We legislate and regulate and intervene, but still the patient languishes. It's a worldwide failure of the institutions of money and credit. I see in the papers that Banca Monte dei Paschi di Siena is in the toils of a debt crisis. For the first time in over 500 years, the foundation that controls this ancient Italian institution may be forced to sell shares. We've all heard of hundred-year floods. We seem to be in a kind of 500-year debt flood.

Many now call for more regulation—more such institutions as the Treasury's brand-new Office of Financial Research, for instance. In the March 8 *Financial Times*, the columnist Gillian Tett appealed for more resources for the overwhelmed regulators. Inundated with information, she lamented, they can't keep up with the institutions they are supposed to be safeguarding. To me, the trouble is not that the regulators are ignorant. It's rather that the owners and managers are unaccountable.

Once upon a time—specifically, between the National Banking Act of 1863 and the Banking Act of 1935—the impairment or bankruptcy of a nationally chartered bank triggered a capital call. Not on the taxpayers, but on the stockholders. It was their bank, after all. Individual accountability in banking was the rule in the advanced economies. Hartley Withers, the editor of *The Economist* in the early 20th century, shook his head at the micromanagement of American banks by the Office of the Comptroller of the Currency—25% of their deposits had to be kept in cash, i.e., gold or money lawfully convertible into gold. The rules held. Yet New York had panics, London had none. Adjured Withers: "Good banking is produced not by good laws but by good bankers."

Well said, Withers! And what makes a good banker is more than skill. It is also the fear of God, or, more specifically, accountability for the solvency of the institution that he or she owns or manages. To stay out of trouble, the general partners of Brown Brothers Harriman, Wall Street's oldest surviving general partnership, need no regulatory pep talk. Each partner is liable for the debts of the firm to the full extent of his or her net worth. My colleague Paul Isaac, who is with me today—he doubles as my food and beverage taster—

has an intriguing suggestion for instilling the credit culture more deeply in our semi-socialized banking institutions.

We can't turn limited liability corporations into general partnerships. Nor could we easily reinstate the so-called double liability law on bank stockholders. But what we could and should do, Paul urges, is to claw back that portion of the compensation paid out by a failed bank in excess of 10 times the average wage in manufacturing for the seven full calendar years before the ruined bank hit the wall. Such a clawback would not be subject to averaging or offset one year to the next. And it would be payable in cash.

The idea, Paul explains, is twofold. First, to remove the government from the business of determining what is, or is not, risky—really, the government doesn't know. Second, to increase the personal risk of failure for senior management, but stopping short of the sword of Damocles of unlimited personal liability. If bankers are venal, why not harness that venality in the public interest? For the better part of 100 years, and especially in the past five, we have socialized the risks of high finance. All too often, the bankers who take risks don't themselves bear them. By all means, let the capitalists keep the upside. But let them bear their full share of the downside.

In March 2009, the *Financial Times* published a letter to the editor concerning the then novel subject of QE. "I can now understand the term 'quantitative easing,' wrote Gerald B. Hill of Stourbridge, West Midlands, "but . . . realize I can no longer understand the meaning of the word 'money.'"

There isn't time, in these brief remarks, to persuade you of the necessity of a return to the classical gold standard. I would need another 10 minutes, at least. But I anticipate some skepticism. Very well then, consider this fact: On March 27, 1973, not quite 39 years ago, the forerunner to today's G-20 solemnly agreed that the special drawing right, a.k.a. SDR, "will become the principal reserve asset and the role of gold and reserve currencies will be reduced." That was the establishment—i.e., you—talking. If a worldwide accord on the efficacy of the SDR is possible, all things are possible, including a return to the least imperfect international monetary standard that has ever worked.

Notice, I do not say the perfect monetary system or best monetary system ever dreamt up by a theoretical economist. The classical gold standard, 1879-1914, "with all its anomalies and exceptions . . . 'worked.'" The quoted words I draw from a book entitled, "The Rules of the Game: Reform and Evolution in the International Monetary System," by Kenneth W. Dam, a law professor and former provost of the University of Chicago. Dam's was a grudging admiration, a little like that of the New York Fed's own Arthur Bloomfield, whose 1959 monograph, "Monetary Policy under the International Gold Standard," was published by yourselves. No, Bloomfield points out, as does Dam, the classical gold standard was not quite automatic. But it was synchronous, it was self-correcting and it did deliver both national solvency and, over the long run, uncanny price stability. The banks were solvent, too, even the central banks, which, as Bloomfield noted, monetized no government debt.

The visible hallmark of the classical gold standard was, of course, gold—to every currency holder was given the option of exchanging metal for paper, or paper for metal, at a fixed, statutory rate. Exchange rates were fixed, and I mean fixed. "It is quite remarkable," Dam writes, "that from 1879 to 1914, in a period considerably longer than from 1945 to the demise of Bretton Woods in 1971, there were no changes of parities between the United States, Britain, France, Germany—not to speak of a number of smaller European countries." The fruits of this fixedness were many and sweet. Among them, again to quote Dam, "a flow of private foreign investment on a scale the world had never seen, and, relative to other economic aggregates, was never to see again." Incidentally, the source of my purchased copy of "Rules of the Game" was the library of the Federal Reserve Bank of Atlanta. Apparently, President Lockhart isn't preparing, as I am—as, may I suggest, as you should be—for the coming of classical gold standard, Part II. By way of preparation, I commend to you a new book by my friend Lew Lehrman, "The True Gold Standard: A Monetary Reform Plan without Official Reserve Currencies: How We Get from Here to There."

It's a little rich, my extolling gold to an institution that sits on 216 million troy ounces of the stuff. Valued at $42.222 per ounce, the hoard in your basement is worth $9.1 billion. Incidentally, the official price was quoted in SDRs, $35 to the ounce—now there's a quixotic choice for you. In 2008, when your in-house publication, "The Key to the Gold Vault," was published, the market value was $194 billion. Today, the market value is $359 billion, which is encouraging only if you personally happen to be long gold bullion. Otherwise, it strikes me as a pretty severe condemnation of modern central banking.

And what would I do if, following the inauguration of Ron Paul, I were sitting in the chairman's office? I would do what I could to begin the normalization of interest rates. I would invite the *Wall Street Journal*'s Jon Hilsenrath to lunch to let him know that the Fed is now well over its deflation phobia and has put aside its Atlas complex. "It's capitalism for us, Jon," I would say. Next I would call President Dudley. "Bill," I would say, pleasantly, "we're not exactly leading from the front in the regulatory drive to reduce the ratio of assets to equity at the big American financial institutions. Do you have to be leveraged 89:1?" Finally, I would redirect the efforts of the brainiacs at the Federal Reserve Board research division. "Ladies and gentlemen," I would say, "enough with 'Bayesian Analysis of Stochastic Volatility Models with Levy Jumps: Application to Risk Analysis.' How much better it would please me if you wrote to the subject, 'Command and Control No More: A Gold Standard for the 21st Century.'" Finally, my pièce de résistance, I would commission, staff and ceremonially open the Fed's first Office of Unintended Consequences.

Let me thank you once more for the honor that your invitation does me. Concerning little *Grant's* and the big Fed, I will quote in parting the opening sentences of an editorial that appeared in a provincial Irish newspaper in the fateful year 1914. It read: "We give this solemn warning to Kaiser Wilhelm*: *The Skibbereen Eagle* has its eye on you."

*On further review, the editorial appeared in *The Skibbereen Eagle*'s pages in 1899. The *Eagle* directed its warning towards the Czar of Russia.

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